



BUDGET ADDRESS OF GOVERNOR DENNIS DAUGAARD

THE STATE CAPITOL – PIERRE, SOUTH DAKOTA – DECEMBER 8, 2015

Thank you and welcome.

Today I offer my budget proposal for Fiscal Year 2017. In today's remarks, I'll review the state's economy, our revenues and expenses for the current year, and offer my proposals for next year. Happily, the climate today is much different than when I proposed the budget in January of 2011 when the nation was reeling from recession. We worked together to bring our budget into structural balance and many of you made very difficult decisions on behalf of our state. Today we are stronger than ever because of those tough decisions, and I still appreciate your courage. In the years since, we have been good stewards of the dollars entrusted to us. We have also posted healthy revenue gains since then. This has given us unique opportunities. We've had one-time money to invest in debt repayment, state parks, railroads, and scholarships.

Let's take a look at how the last several years have ended. FY15 marked our fourth consecutive year-end surplus. As you can see, the surpluses have been rooted in both revenue improvements and expenditure savings. The red parts of each bar depict spending which was less than appropriated levels. These have been fairly stable, in the \$7 million to \$13 million range. Most reversions have been in our entitlement areas, predominately in Medicaid. The blue parts of each bar depict revenue received above expectations. Despite pressure to adopt revenue estimates above recommendations and historical trends, we've worked together to adopt conservative revenue projections, with a high probability of attainment. Because of that, FY15 ended about \$10 million above our revised estimates. With these surpluses we've improved our rainy day fund balances and invested in one-time opportunities.

Let's see how these surpluses have affected our rainy day funds. This chart represents our rainy day fund balances. Look at the blue line and the left axis to see the value in dollars. In FY09, FY10, and FY11 rainy day funds remained unchanged at \$107 million. Our reserves grew in FY12 and FY13 to \$159 million. We spent some of those reserves and ended FY14 with \$149 in reserves. And last June we ended FY15 with reserves at \$170.7 million. In total, we've added over \$103 million to our rainy day funds, of which we've spent about \$40 million for disasters and debt reduction. The red line and right axis represents the percentage those reserves represent as compared to the general fund expenditures for that year or the appropriations for that year. In FY09, again following that red line, we had a little over 9% in reserves and that

stayed the same through FY10 and FY11. Then in FY12 we reached 11.7% of reserves, FY13 12.9% of reserves, FY14 11.5% of reserves, and we ended this last year at 12.4 % of our appropriations. Since then, we've managed our reserves at or above 10% of the last five to six years above the 10% target. Nationally, the average state rainy day fund balance is about 5.4% measured just this last spring. We've set a target of about 10%, and we have about \$27.4 million above that. And this year, I'm going to be proposing we use that \$27.4 million to repay more debt. Before discussing that in detail though, let's examine some economic trends.

The South Dakota Council of Economic Advisors regularly considers a multitude of assumptions and economic forecasts. Reviewing this information with experts from all corners of the state helps us provide the best forecast of tax revenues that will be available for the budget. Let's take a look.

IHS Economics produces a US economic forecast each month, that's a national forecast each month. The most recent forecast is between 2.9% to 3.0% GDP growth for 2016 and 2017, stronger growth than US economy has realized over the past several years. When this forecast was reviewed in October with the South Dakota Council of Economic Advisors, it was judged to be too optimistic. In fact, the US economy has not had a calendar year of real GDP growth above 2.5% since 2006. Compared to other forecasts from economists at Wells Fargo and the Federal Reserve, IHS is on the optimistic side, and looking back, they've been consistently overly optimistic over the past few years.

Thus, in consultation with the South Dakota Council of Economic advisors, our Bureau of Finance & Management moderated the South Dakota economic forecast. The moderated forecast is closer to recent trends for employment and income growth, and that moderated forecast was used to develop the revenue projection I'm going to be presenting you today. We expect continued economic growth, but at slow and steady rates over the next two years, not accelerating rates.

Inflation is another important variable, as inflation has a direct impact on sales tax growth, simply stated higher inflation creates stronger growth in tax revenues, but lower inflation that we've seen recently, begets more moderate growth in sales tax. Inflation is projected to be in the 0%-2.4% range over the next two years, which is lower than historical rates. We're assuming no major economic disruptions from abroad. Although volatile foreign economies can have an impact on the US economy and South Dakota, major disruptions are impossible to predict, and we're not assuming any will occur. In South Dakota, we've also had healthy housing and construction activity over the past year, and we anticipate that will continue in 2016 and 2017.

Lastly, and I will cover this in more detail in a later chart, we anticipate lower farm income in the next couple of years. Lower commodity prices are leading to lower net income than recent highs, and this means less spending in the agriculture sector, and lower sales tax collections as a consequence.

These next charts show IHS Economics' most recent forecast for the national economy (the US economy) using four key indicators. The grey bars show actual numbers – these are history, the blue bars show the forecasts – going into the future.

The first chart, top left, shows the US real Gross Domestic Product in trillions of dollars. Real GDP is considered the most comprehensive measure of the US economy. Real GDP was flat during the recession years. Since then, GDP growth has been around 2.5%, slower than the 3.0% rates seen before the recession. IHS Economics forecasts stronger growth in 2016 and 2017, as I mentioned earlier rates of 2.9% and 3.0%, respectively.

The top right chart shows US employment. The US economy lost about 8.7 million jobs during the recession, and it was nearly seven years after the recession began that those jobs were recovered. The job growth forecast for 2016 and 2017 for the nation is growth of 1.6% and 1.4% respectively.

The bottom left chart shows millions of US housing starts. Although housing starts have grown, the nation has not yet recovered to levels seen before the recession, but is forecast to do so, as you can see, nearing 1.5 million units by 2017.

The bottom right chart shows US Unemployment. The annual unemployment rate reached nearly 10% in 2009 in our nation. Since then it has steadily dropped. The forecast for 2016 and 2017 is to remain about 5% nationwide.

Now, we'll consider South Dakota-specific economic indicators; four of them – employment, nonfarm income, housing starts, and unemployment. As I mentioned, the South Dakota Council of Economic Advisors met with the Bureau of Finance and Management in October and reviewed the latest IHS Economics forecasts for the South Dakota economy and deemed them too optimistic so we're going to look at the moderated forecast. These moderated forecasts were used to develop revenue forecasts for FY16 and FY17.

First, top left, South Dakota employment. During the recession, South Dakota realized job losses, as did the nation, but only at about half the rate of the US economy. We recovered those jobs more quickly than the nation, and we continue to grow our employment. Most recently in October 2015, our employment was growing 1.9% year-over-year. We anticipate growth of 1.4% in 2016 and 2017, adding approximately 6,000 jobs per year.

Next chart, top right, South Dakota nonfarm income. Income growth was flat during the recession years, but has grown fairly steadily since. South Dakota nonfarm income is forecast to grow 4.6% and 4.8% in 2016 and 2017.

Bottom left is South Dakota housing starts. Housing starts dropped dramatically, even in South Dakota during the recession. In 2012 through 2014, we rebounded to over 4,000 housing starts per year, and we forecast similar levels for 2015, 2016, and 2017.

Last chart, bottom right is South Dakota unemployment. After levels of 5.0% or worse during 2009 and 2010, our unemployment rate has improved, and we project it around 3.0% steadily over the next few years. The bottom line – the moderated forecasts project continued slow and steady growth in South Dakota. We continue to be conservative in economic and revenue forecasts as we’ve done the past several years.

This chart shows Net Farm Income against sales tax collections on farm machinery. As you know, in South Dakota, many purchases by ag producers are exempt from sales tax, but sales and use tax does apply to farm machinery.

The bars use the left scale to show South Dakota net farm income. Look at 2002 and 2006, see how the low income during those drought years. Look at 2008 and later. Income is strong, with high crop prices and big harvests. In 2014, farm income dropped and is expected still lower in 2015. Harvests were good, but prices are lower.

What does this mean to our budget? The red line and the scale on the right, estimates farm machinery sales tax collections. Look at 2007 and later on that red line. Tax incentives and strong farm income fueled machinery purchases, and sales taxes shown here grew from \$17.4 million in FY08 to nearly \$44.0 million in FY14, and of course this boosted our tax revenue during those years. Now we see fewer farm machinery purchases, which mean less sales tax. In FY15, machinery sales taxes declined 23.5%. In FY16, year-to-date it’s down another 15%. So of course lower net farm income means less farm machinery sales tax, and this means our overall growth in total sales tax will be below average until farm income and equipment purchases level out.

Let’s now see how all those economic variables will affect revenues for the remainder of the current budget year and for next year. I’ve used this chart in the past to explain why we need to be careful as we forecast revenue. This chart compares ongoing general fund revenue as originally adopted to actual revenues ultimately received.

For example, the first line, FY06, the legislature in March of 2005 adopted a \$1.001 billion revenue estimate. Actual receipts were better, at \$1.013 billion.

In FY07 and FY08, before the recession, the forecasts were still pretty close, with actual collections a little lower than originally forecast.

Then in FY09 and FY10, during the recession, adopted estimates were too high and actual collections were significantly lower. We had to use one-time federal stimulus money to balance our budget.

In FY11 through FY14, we adopted more conservative estimates. In those years, actual collections exceeded the original adopted estimate. Consequently, we had extra one-time money to spend in those years.

For FY15, last year, we adopted original estimates that were above what BFM or LRC recommended, and actual collections were coming in lower, forcing a mid-year revision downward. Thankfully we were able to reduce spending in some areas and still ended the year in the black.

This year, so far, actual revenue is above estimates, and it appears we can increase our estimate for the current year by \$8.4 million. This means we have additional one-time money to invest for FY16. This also helps provide a larger increase than we would otherwise be able expect for FY17.

Now let's look at the detail of our current fiscal year's updated revenue forecast. This is the current year; we are almost midway through it. Sales and use tax is revised higher by \$3.7 million as our collections started the year a little above projections.

Lottery has been revised higher by \$1.1 million, and this number includes instant, online, and video lottery receipts to the general fund. Video lottery is currently running 4.1% higher than a year ago.

Contractor's excise tax has been revised higher by \$3.1 million. Strong collections to finish FY15 and sustained growth in FY16 reflect continued strength in South Dakota construction activity.

The insurance company tax – up \$2.8 million as collections finished FY15 ahead, and we anticipate that growth to continue in FY16, with increases in property, casualty, and health premiums.

Unclaimed property revenues were revised \$1.0 million higher due to higher receipts so far this fiscal year, and of course we get the vast majority of this money in November so we know what the vast majority of that collection will be, and claim payments are running below last year's pace.

Licenses, permits, and fees are up \$0.5 million as collections have been slightly ahead. Tobacco taxes have been revised higher. We had two strong months of collections at the beginning of the fiscal year.

The bank franchise tax has been revised lower, mainly due to credits paid in the current year, with estimated quarterly payments higher than actual liability.

Other ongoing receipts have been revised slightly lower also. So the revised total ongoing revenue is \$1,441.5 million that is \$8.4 million higher than the originally adopted forecast. Remember that \$8.4 million number because it will contribute to one time spending opportunities this year.

Now let's look at next year, our FY17 projected revenue – this is the year beginning July 1, 2016. This shows the revised FY16 revenues which we just reviewed in the last chart, so the \$1,441

million is the increased number. It includes the \$8.4 increase. We're building off that and then we are going to show the FY17 forecasts beginning July 1, 2016, and ending June 30, 2017.

Sales and use tax for FY17 is estimated at \$904.9 million, an increase of \$32.2 million over revised the FY16 number. This is a growth rate of 3.7%; it's less than historical growth, but still assumes a steady economy.

The lottery category, including video lottery, is forecast to grow \$2.2 million in FY17.

Contractor's excise tax is forecast to grow \$4.1 million in FY17, a 4.1% growth rate, indicating continued healthy construction activity in South Dakota. Insurance company tax is up \$5.1 million, a 6.1% increase over the revised FY16 estimate due to anticipated premium increases in property, casualty, and health insurance.

Unclaimed property is down \$7.4 million compared to FY16, and this is because we must be conservative with this source of revenue, because of its unpredictability. We really don't know where this is going to come in until November of each year. We don't have algorithms to use, we can't tie it to economic forecasts, and all we can do is look at history. And so what the FY17 estimate represents is the lower end of actual collections from our two largest holders over the past three years.

Licenses, permits, and fees are up \$2.0 million, mostly from growth in security fees anticipated for FY17.

Tobacco taxes are estimated to be down by \$0.4 million, due to the long term decline in smoking that is expected to continue.

Bank franchise tax is up \$6.0 million for FY17. Remember, the FY16 estimate was revised downward because overpayments. We expect FY17 closer to normal at \$11.4 million.

Other ongoing receipts are up \$7.1 million, due to higher receipts from trust funds and also related to the corrections budget restructuring I will be talking about a little bit later. Total ongoing revenue is projected at \$1,492.6 million, up \$51.1 million compared to the revised number which itself was up \$8.4 million, so add that \$51.1 million to \$8.4 million and it means the new ongoing revenue available in FY17 is \$59 million.

This chart compares ongoing revenue available to cover ongoing expenses for the past three budgets. Two years ago at this time we had the luxury of a \$6 million structural surplus that the Legislature left on the bottom line. The then current year revised ongoing revenue growth was \$33 million. To that we added \$40 million of ongoing revenue growth for the following budget year. That totaled \$79 million of new ongoing revenue to budget for ongoing expenses.

Then last year we didn't have any money available on the bottom line, which is more typical, but we also had to decrease the then current year revenue by \$11 million. Again, we adopted a

revenue estimate that was beyond recommendations by either BFM or LRC and so we had to decrease our revenue projection by \$11 million. Combining this with budgeted year revenue growth of \$60 million allowed just \$49 million of ongoing revenue growth when we built the FY16 budget.

Today we are able to increase our current year revenue growth by \$8 million because we were more conservative when adopted our revenue estimate last March, and we add it to the budgeted year's ongoing revenue growth of \$51 million, and again this provides that \$59 million of new ongoing revenue toward new FY17 expenses.

So again, being conservative on revenue projections plays a very important role. By being conservative, this increase in revenue in the current year allows increased ongoing spending in the following budget year, in this case, FY17.

So let's shift gears and talk about how I am proposing to utilize the \$59 million we believe will be available to us next year. Let's look at expenses as an overview. In the past, I have recommended utilizing one-time dollars to reduce liabilities or ongoing expenses, and this year, my proposal uses one-time funds in FY16 to repay debt held by the Board of Regents and the Technical Institutes. By doing so, we can repurpose the avoided payments to freeze tuition at both the Board of Regents and the Technical Institutes.

Secondly, the formula we use for Medicaid would require a 2.1% increase for this year, it's based on a prospective inflation consideration, but I'm proposing to give an additional 0.6%, and also to improve rates of specific providers.

Next, the budget also proposes to eliminate dependence on volatile federal/other funds within several agencies listed here. Also, this year's share of the federal medical assistance percentage (FMAP) decreased from 48.38% to 45.89%, or 2.49%. This savings is going to total \$22 million, which helps augment new revenue growth of \$59 million, making a total \$81 million in improvement.

My budget proposal includes budget authority to expand Medicaid, if we can do so without any general fund cost. I'll discuss that in more detail in a few minutes.

Finally, the Blue Ribbon Task Force has offered recommendations relating to teacher salaries and school funding, and I look forward to working with the Legislature to propose dedicated funding to address these issues.

Now, let's look at expenses in more detail. For the Board of Regents I'm proposing a 2.5% increase, plus an additional \$2.9 million, or 1.4%, to freeze tuition, by using one-time funds as I said to repay Board of Regents bond debts, thus eliminating the bond payments they are making.

For the Technical Schools I am proposing a 2.7% increase, and as with the Board of Regents, using one-time funds to repay Technical Institute debt so the avoided payments can be instead used to freeze tuition.

Our formula would give Medicaid providers an increase of 2.1%, and my proposal adds 0.6% to that, for a total of 2.7%, so all providers 2.7%. My proposal would offer still more whose reimbursement rates are less than 90% of their allowed costs – and more about that in a minute. This would be the first of three steps over three years toward getting all provider reimbursement rates to at least 90% of their allowed costs.

My proposal includes a 2.7% cost of living for state employees, as well as movement towards their respective market value.

Finally, the funding formula for state aid to K-12 education, and special education, would be a 0.3% increase. Any proposals made as a result of the Blue Ribbon Task Force will be on top of that.

So what do those increases mean in dollar expenditures? For education, \$21.8 million, this includes increases of 0.3% for state aid, as well as \$8.8 million for the state aid to special education tri-annual rebase. As I mentioned earlier, my proposal also includes increases of 2.7% for Technical Institutes and additional funding for both the Board or Regents and Technical Institutes to freeze tuition. Again – this does not include any recommendations from the Blue Ribbon Task Force. That would be in addition to this proposal.

State Employee Compensation – \$12.1 million, that would be a 2.7% market adjustment and specific increases for the career bands, along with a 2.5% movement towards market value. We've also seen favorable conditions in our state health plan, which I will discuss in a moment.

Medical Services and Provider Assistance – \$9.0 million. The 2.7% provider increase that I talked about a minute ago for all providers will cost \$31.0 million, but that amount can be offset by \$21.9 million in savings from the FMAP change, for a net increase of \$9 million. This provides a 2.7% inflationary increase and it also includes funding for the second half of the Juvenile Justice Reinvestment Initiative.

All the rest – \$16.4 million, almost half of that is the last step in our four steps to our 2% maintenance and repair reserve, so we would finish that four-year program this year. It would also increase money for drug and DUI courts, and it would correct the funding dependencies in those six agencies I showed on the screen earlier.

The total of \$59.3 million matches the new ongoing revenue we are projecting above the FY16 adopted revenues. Now more detail for each of these four lines. Look at education increases of \$21 million. Here's more detail of that.

State Aid to Special Education – \$8.8 million, this is the triennial rebase which is calculated on past statewide average expenditures, increased for inflation.

State Aid to General Education – \$4.2 million, this includes 0.3% inflation in general education. It takes the per student allocation under my proposal to \$4,891.39 per pupil. This also includes an increase of \$1.6 million as the Limited English Proficiency Adjustment will no longer be covered by the Workforce Education Fund.

The Board of Regents and Maintenance and Repair – \$3.3 million, this is the fourth and final year of the four-year plan we started several years ago to get our maintenance and repair budgets to a level which equates to 2% of the replacement value of our state buildings. This amount is the cost for the regental academic buildings.

The Technical Institutes Formula – \$1.2 million, this increases funding for the Technical Institutes to \$3,487.39 per student, assuming 5,905 FTE. It includes money to pay for National Guard tuition in the formula.

Dual Credit Increased Demand – \$566,000. We have seen the dual credit program succeed well beyond our projections. We originally budgeted under 3,000 credit hours for the dual credit program last year, but based on this program's success we are budgeting 21,300 credit hours for next year. As I've said before, this is a win for students, high schools, universities and tech schools, and the state, and I'm very pleased to see its continued growth.

This year, I am proposing that we set the student share at one-third of the cost, so that it will increase gradually with tuition. That means, next year, the student would pay \$48.33 per credit, which is a significant savings over approximately \$300 per credit hour, if they wait until they're in the post-secondary schools to take those same hours. This bargain encourages higher utilization, which is beneficial to post-secondary institutions and even more so to the students themselves. It makes these students more likely to attend a post-secondary school because they start with credits under their belt. It also makes these students more likely to find success because they can take an easier load as they are adjusting to the new school environment because they've already got some credits earned. It also makes them likely to continue and to graduate, and that's a problem we have in our post-secondary schools – getting kids to graduate.

The next line, South Dakota Opportunity Scholarships – \$434,000. Last year you adopted my recommendation to increase the value of the Opportunity Scholarship, the first increase since the scholarship was created over ten years ago. We are phasing that in over four years, so this would be the second year as a second new class enters college, this funding allows that second class of students to receive the increased \$6,500 total award over four years. This funding helps keep the scholarship competitive so it continues to be an incentive for students to take a rigorous high school curriculum and stay in South Dakota for college. Over 3,900 recipients are projected for the coming school year.

The next line item is the tuition freeze – \$425,000. I mentioned using one-time money to pay off debt and after the savings generated by paying off the debt we'll still need a little bit of money to add to the formulas to freeze the tuition for the Board of Regents and the Tech Institutes. The \$425,000 will do it.

Finally, miscellaneous increases and decreases all net out to be \$2.9 million. All add up to the \$21 million seen in the last chart total for education.

I've mentioned a couple times, again I want to restate it, – I'm proposing to prepay Regents and Technical Institute debt. This will free up ongoing funds that are currently used for those bond payments, then that savings can allow those Board of Regents and Tech Schools to freeze at their tuition. Let's look at that next.

I'm recommending early repayment of four bond issues. The first column shows what these bonds financed. The first two issues funded Board of Regents science labs. If these bonds look familiar, it's because two years ago one-time funding was utilized to prepay half of those bonds we were paying out of the general funds. This repays the other half that the Board of Regents is paying out of their budgets. The recommendation would pay the remaining bonds for the science labs, which the Board of Regents was paying using other funds. The third issue is a 2007 Series Bond associated with Western Dakota Tech and Southeast Tech and the fourth issue is a 2014 Series Bond associated with Lake Area Tech, Mitchell Tech, and Southeast Tech.

The second column shows the payoff amount for the bonds, the total of \$42.3 million, and prepaying those bonds will save \$3.7 million annually, which again would be repurposed by those institutions to fund the tuition buy downs at Board of Regents and the Technical Institutes.

We also save \$14.6 million in future interest and fees, primarily from the first two bonds listed. Prepaying these will result in substantial interest and fee savings over the life of the bonds as you can see their yields are both over the 4.7% from the far right column.

The Series 2014 bond payoff doesn't have any ongoing savings tied to it; however, it is beneficial to prepay this bond to pre-fund debt service. These four bonds, if they're if prepaid, result in \$3.7 million in ongoing savings and \$14.6 million in avoided interest and fees. Prepaying these debts allows us to keep college affordable, by freezing tuition at our post-secondary institutions.

The Board of Regents in-state resident tuition freeze for on-campus students for the 2016-2017 school year costs \$3.2 million. The Technical Institute tuition freeze costs \$900,000. The total cost of freezing tuition is \$4.1 million.

My proposal as I said will save about \$3.7 million in ongoing debt reduction payments, so we need to add an additional \$429,000 of general funds reach the total cost of the tuition freezes. Remember – although these dollars go into the budgets of the Regents and the Technical

Institutes, they don't create more funds for those institutions to spend. Those dollars go right into the pockets of our students, in the form of lower tuition and fees than they would otherwise pay.

I'm also proposing a change this year in how we budget for National Guard tuition incentives. I'm recommending that the Board of Regents abolish a fee called the University Support Fee, and instead raise regular tuition rates by the same amount. That change will be cost-neutral to most students, but it better leverages federal tuition reimbursement for National Guard students, who will save about \$141 per course.

This will cost the Board of Regents an additional \$315,000 annually, and I am proposing that the state cover that cost. In addition, I am proposing that the state general funds for National Guard tuition be moved from the National Guard budget and into the Regents and and Technical Institute budgets, so the institutions can more directly manage those costs in the future.

Before I leave the topic of education funding, I'd like to speak for a moment about the Blue Ribbon Task Force. I'd like to start by thanking the task force members for the considerable time and thought they dedicated to that effort. This was an exhaustive process of public input, data collection, analysis and research, and policy discussion. The final report is an excellent overview of the history of education funding in South Dakota, the current situation, and policy ideas for the future. I hope you have all read it. I have read it several times, and I recommend it to anyone who is interested in this issue. In response to the final report, I am developing proposals that I will discuss, in detail, at the State of the State address.

For today though, I'd like to make a few points. I agree that South Dakota needs to increase teacher salaries to remain regionally competitive and to avoid a teacher shortage. I also agree that significant progress in this area will require new state funds. New state funds create an opportunity to fix longstanding inequities and inefficiencies in the current formula, and I agree with the task force that we should not lose that opportunity. The Blue Ribbon Task Force was not created to write a report that will occupy shelf space at the State Archives. The public expects us to be bold and to make real progress this year, and I look forward to continuing that discussion in my State of the State and in the coming legislative session.

Moving on, here are my recommended general fund increases for our state employee workforce. I am proposing \$9.2 million for market adjustments for permanent state employees, and an additional \$4.3 million to move employees closer to the market value of their jobs. I'll have more details on that in just a moment.

I'm also recommending a decrease of almost \$1.5 million in general funds for the employer-paid portion of the state employee health insurance plan. Due to lower than anticipated claims we can make this reduction and still keep our health insurance reserve at a fully-funded level. This equates to reduction of about \$275 per benefitted employee.

Here are the details on my recommendations for our state employee salary policy. Last year I directed the Bureau of Human Resources to implement a new market-based general pay structure for employees not in career bands. For those I proposed a 2.7% market adjustment, based on regional salary surveys and inflation.

Employees in the career bands will receive a market adjustment which is dependent upon the market adjustments in their profession. For information technology, accountants, and auditors – 0% increase. For nursing – 1.0% increase. For environmental scientists – 2.5%, engineers – 2.7%.

Progress continues in developing a performance-based model for the general pay structure, however this year I'm recommending a flat 2.5% movement towards market value for employees who are below the market value of their job.

I'm also recommending pay-for-performance increases of 0% to 4.5% for the career band families as we've done the past years, with some changes to allow higher performing employees to increase their base pay above market value and to move employees who are further behind market value ahead faster.

Finally, I'm also proposing to bring all pay grades up to at least 85% of true market minimums. The jobs affected include building maintenance workers, secretaries, correctional officers, and mental health aides.

Here are my proposals for FY17 for medical and provider assistance. Provider inflation in dollars is \$16.9 million. This is the 2.7% inflation adjustment for all providers in FY16. Of course this supports providers such as nursing homes, community support providers, physicians, and many other provider types.

Growth and utilization in FY17 we're projecting \$6.8 million growth in current Medicaid eligibles. In numbers it's 1,708 individuals, which is 1.4% growth of current enrollees.

Also, the Juvenile Justice Reinvestment Initiative – Last year I proposed implementation mid-year, January 1 we began initiating the Juvenile Justice Reinvestment Initiative so I needed funding for the last half FY16, and you adopted that. This proposal adds the other six months to fund a full year – for FY17 that costs \$3.3 million.

I'm also proposing \$1.3 million to fund year one of three years of rate improvements for providers who are being reimbursed below 90% of allowable costs. I mentioned this a minute ago, it will cost \$1.3 million this year to get those providers, some are getting as low as 60% of their allowable costs, get them a third of the way toward the 90% of cost mark. More about that in the next chart.

FMAP – This year we are experiencing a decrease in our federal medical assistance percentage, or FMAP rate. A 2.49% decrease from 48.38% to 45.89%. This means state general funds will pay \$45.89 of every \$100 of Medicaid costs in FY17.

Other miscellaneous increases and decreases net to \$2.5 million. Those include things through the departments of Social Services, Health, and Human Services. \$1.6 million of this amount is specific to correctional healthcare costs and \$800,000 is to fund the rural healthcare assistance programs in the base, rather than annual one-time special appropriations, we've done that by special appropriations annually, well it's time to put it in the base.

Note that none of these proposals, I'll say it again – none of these proposals are connected to the expansion of Medicaid. Regardless of whether you agree that we should expand, or whether the conditions are right to expand, each of these proposals is justified in any case.

I mentioned I would give you more detail in the rate provider analysis, this past summer I asked the Department of Social Services, Department of Human Services, Department of Corrections, and the Bureau of Finance and Management to analyze provider rates. They analyzed 866 providers serving 48,900 individuals and compared the rates they were being paid under Medicaid to their latest cost reports because each of them have to file cost reports with the state.

They summarized their findings in a spreadsheet and three tiers were created, according to the amount of allowable costs being covered by the rate we are paying. One tier of service categories is currently being reimbursed at less than 85% of allowable costs. Some are being reimbursed at only 62% of costs. Another tier of service categories are currently being reimbursed at rates from 85% to 99% of their costs. And still another tier of service categories are currently being reimbursed at 100% or greater. This chart shows these three tiers and the funding they would receive under my proposal.

The first column is those three tiers. The 2.1% column shows the funding these providers will receive based on a provider inflation rate that's in our formula. The 0.6% column shows the additional 0.6% that everybody would get if you agree with my proposal beyond what is statutorily required. The "one-third to 90%" is the funding for the first year of a three year plan to get all providers to at least 90% of their allowable costs. And of course the last column adds all three elements to show the total general fund proposal of just over \$7 million.

As I mentioned earlier, none of this is connected to the expansion of Medicaid. Regardless of whether we expand, this adjustment to rates is based on data, and I recommend it. But let's now turn to that question let's turn to the question of Medicaid expansion. You know that I have been unwilling to support expansion of Medicaid in South Dakota in the past, primarily because of the cost to the state. Even though the federal government will pay 100% of the claims costs in the early years, states are required to assume 10% of these costs by calendar year 2021, and it will be fully felt in FY21 for us.

Here are our updated estimates of the state general fund costs to expand Medicaid in South Dakota. In FY17, our claims and administrative costs would total \$12 million. That goes up to \$28 million in FY18, then \$34 million in FY19, \$46 million in FY20, and \$57 million in FY21. At that point, the shift from 100% to 90% federal share would be complete. And at that point the state would be paying the full 10% and costs thereafter, unless the laws change, would only grow with inflation. Remember the \$57 million number, that's the far right side. That's the total costs of the state in FY21.

Without a plan to cover these state general fund expenses, I have opposed expansion. I haven't said "never." I've always said "not now" we just didn't have the money. And for three years we have had communication with federal officials about ways to make expansion work for South Dakota. Our early conversations were not fruitful, but in the past year that has changed. It has changed because of conversations among the state, the federal government, and South Dakota tribes about the way we provide healthcare services and finance them to Native Americans. This has been a longstanding problem in South Dakota, and I'd like to go into a little more detail.

The United States Government has a treaty obligation to provide health care to Native Americans, and that obligation is supposed to be met by the Indian Health Service. If a Native American who is Medicaid eligible seeks care, the Medicaid program covers that care and if it's provided through the Indian Health Services, Medicaid is reimbursed 100% from the federal government.

In the most recently completed fiscal year, IHS spent \$69.2 million providing health care to Native Americans who were also Medicaid eligible, 100% federally reimbursed. That's how it is supposed to work for all Native Americans, but it doesn't always happen that way. Many Native Americans in South Dakota are not able to be served by IHS. Maybe there's no IHS facility in their area, maybe IHS doesn't have the right specialists available that are needed, or maybe there are long wait times and there's an emergency. No matter the reason, when a Native American who is Medicaid eligible does not get care through Indian Health Service, but instead goes to another provider, the cost is shared between the state and federal government at the normal FMAP rate.

Last year, our Medicaid program spent \$139 million on health care for Native Americans at the normal FMAP rate, and \$67 million of that money was state general funds. If we can save this \$67 million, remember, we only need \$57 million to cover costs in 2021, and \$57 million is a very conservative estimate of our costs, and I look forward to describe how that was calculated with you.

Keep in mind – Native Americans have a treaty obligation from the United States Government for healthcare, and when South Dakota has to cover these costs, the federal government is not meeting that treaty obligation. If more Native American health care expenditures could be 100% federally funded – as treaty obligations require – the savings of state funds could be up to, as we saw, \$67 million, and that's enough savings today to pay for the costs in 2021.

Making this change would also free up more IHS funds, so they would be able to provide better services to Native Americans at their facilities.

In the past, the federal government has not been receptive to fixing the IHS reimbursement problem. Governor Janklow tried to change it and couldn't. Governor Rounds sued in federal court over it and lost. But now, the federal government is willing to listen. For the first time, we have the opportunity to solve this longstanding reimbursement problem.

Earlier this year a workgroup of individuals representing South Dakota tribes, legislators, the executive branch, and the health care industry began discussions with the Federal Health and Human Services Department and with the Indian Health Service to work through these issues and to explore them. There have been several productive meetings and HHS is currently in the process of reviewing comments to guidance they issued last month.

We are working to save at least \$57 million, the cost to South Dakota in FY21 when we must bear 10% of the expansion expense. But it is only possible if we expand Medicaid at the same time. Any change to our state Medicaid program is subject to approval by Health and Human Services and it also requires tribal consultation. Health and Human Services will not approve a change in how IHS reimburses our state unless we use the proceeds to fund expansion. This is a very complex area and making something work will be difficult. I cannot tell you today that everything will come together. But if it does, we should seize that opportunity I believe. It offers the opportunity for better healthcare for Native Americans in South Dakota and it will solve the longstanding IHS reimbursement problem.

If we can find a way to transition enough of these expenditures to 100% federal reimbursement, we will have enough funds in our existing general funds budget to cover the state match required by 2021. Not just tomorrow, not in FY17, or FY18, or FY19, or FY20, but FY21. Let me say that again. This solution is aimed at solving the future need, not just next year, or the next, but the need in FY21.

So, who benefits if we expand Medicaid, who would benefit? Well, over 50,000 adults – and our calculations are assuming 55,000; we've added 10% to the number – many of whom cannot earn enough to gain subsidized coverage. Tribal members, whether low income or not, because IHS will enhance quality and access to health care for a population who is badly underserved.

In addition, this change would benefit counties, because they will save much of the \$6-8 million in poor relief expenditures they send to hospitals annually. It will also help sheriffs with jails, as well as state prisons, because they will avoid the medical costs for indigent prisoners who are hospitalized beyond 24 hours. It will benefit hospitals, who will be able to reduce their charity care expense. Now that expense is passed on to other patients like us. Hospitals would also see fewer uninsured adults seeking emergency room care. All Medicaid providers –nursing homes, community support providers, group homes and others – because significant savings in

Medicaid could allow us to improve reimbursement rates in the future. What if we can save more than \$57 million? There's an opportunity to improve rates for other providers.

Now, I know some of you are not excited about expanding Medicaid, and I still share some of your thoughts. It bothers me that some people who can work will become more dependent on government. I hate that! I hate dependency. It bothers me that a single adult could choose to go on Medicaid rather than work a minimum wage job to qualify for insurance on the health insurance exchange. But we also have to remember the single parent with three children. Between work and child care, a parent in that situation sometimes can't work enough hours to get insurance. They simply can't pay for it. They can't exceed the poverty line, and they can't get subsidized coverage. They just can't insure themselves at all.

We have to remember that federal healthcare reform has created the absurd scenario in which a person at 101% of poverty can get highly subsidized insurance on the exchange, but a person at 99% of poverty can't. We have to remember our Native Americans, whose forefathers were given a promise by our federal government. We should expect the federal government to meet that obligation.

Now this is a complicated decision, and we are going to have to all weigh the positives and negatives. In my mind, the opportunity to end this longstanding IHS reimbursement issue, to gain coverage for more South Dakotans, to improve the health care for Native Americans, to save money for counties and Medicaid providers, and to potentially save millions in state dollars, I believe those things outweigh the negatives.

So, my budget proposes \$373 million of additional federal fund expenditure authority, and 55 full-time equivalent employees to handle the new eligibles. No state general funds are proposed.

I also want to be clear – this is not a done deal. Our talks with the federal government have been promising, but there is still work to be done, and there's still the potential for this to fall through. Expansion costs must be covered by current general fund budget, or I will not support it. HHS and IHS must do what they need to do to make it work. Our tribes must agree with these changes. And I will not support expansion unless the Legislature supports it also. The Legislature can provide that support by passing a budget that includes this \$373 million in federal fund expenditure authority. If the Legislature pass that budget item, it will give me the ability to submit a plan amendment to HHS to expand Medicaid – if, and only if, all the other conditions are already met. This is the process we've always used to make changes in Medicaid, and it is the right approach to take now. Again, this is not a done deal. There are many moving parts, but I believe we should seize the opportunity if we can make it work.

Moving on from Medicaid – returning to our proposals for ongoing expenses. These are my recommendations for changes in all other areas I haven't mentioned already.

Maintenance and repair – \$7.2 million, similar to the regental institutions, the Bureau of Administration is charged with taking care of our state owned buildings. This is the fourth year of a four-year plan to get us to 2% of replacement value for all our building, so this would be our last year we'd see this line item.

Department of Corrections – \$5.5 million, they have federal and other fund cash across the department and income streams, primarily at the State Penitentiary where the population has required additional security measures. The funding change from cash to the general funds will structurally balance the entire department, and make those expenditures more transparent. This \$5.5 million general fund expense will be partially offset by an additional \$4.6 million of other funds that will then be placed into the general fund, as opposed to being held and spent as other funds.

Correctional health – \$1.6 million, this includes \$970,000, almost a million dollars for treating inmates with hepatitis C, as well as contractual and inflationary increases.

Drug/DUI courts – \$934,000. They continue to be a successful alternative to incarceration and have helped to reduce recidivism. This funding establishes a drug court in Brookings County, and expands the drug courts in Minnehaha and Pennington counties. This increased funding will bring the number of drug/DUI courts in South Dakota to 14 courts.

Miscellaneous increases and decreases – \$1.2 million. Those are a number of budget adjustments across state government.

I mentioned earlier a few other things in state government that I would like to address in this year's budget. All of these items are located within the other categories that I discussed earlier but let me break a few of them out.

Special education rebase – \$8.8 million. This is required every three years when we recalculate the cost to provide special education services to different categories of students depending upon their severity of education needs.

Corrections reduction – I just mentioned that so I won't repeat it.

Secretary of State – \$848,000. I am recommending a change to the Secretary of State's budget, to allow the Secretary to retain a larger share of fees collected to fund the business and uniform commercial code activities internally, with other funds, thus requiring less general funds in the Secretary of State's budget. This combined with a user fee package will pay for increased costs and a new online business filing system to streamline their operations while holding the general fund harmless.

Department of Labor and Regulation – \$525,000. The Department of Labor and Regulation continues to face decreases in federal grant awards, while costs to provide this needed service increases. My budget structurally fixes this shortfall while also cutting some staff.

Department of Veterans' Affairs – \$500,000 of their other fund cash has been transferred to the general fund, my proposal is to repeal that transfer in order to right size the budget at the State Veterans' Home.

Attorney General – \$390,000. Funding for Attorney General will be used to alleviate the structural shortfall within personal services that has been caused by increased overtime.

As I mentioned before, I'm proposing using reserves and other one-time funds to repay debt. Also, FY16 revenues are higher than adopted in FY16 expenditures are projected to be less than budgeted levels. These and other sources will cover the debt repayment and provide for other one-time spending opportunities in the current year. Let me detail those.

First, where did the money come from? For the nominal surplus the Legislature left a \$10,000 surplus on the bottom line in FY2016. Increased ongoing revenues in the current fiscal year are \$8.4 million, you saw earlier. I'm proposing cash transfers from Department of Corrections, the Petroleum Release Compensation Fund, and South Dakota Risk Pool the total \$11.8 million. I'm proposing \$27.4 million from reserves as I mentioned earlier. This will still leave reserves at 10% of our general fund spending. A reduction of annual appropriations we budgeted \$12.6 million that I'm going to detail that in the next chart that we do not need to spend this year and we can instead spend it on one-time use. The total of one-time funds available in FY16 is \$60 million. Remember the \$60 million number, but first let's go back to that line item of \$12 million. Where did that come from?

Reduction of some expenditure items. First, the state employee health insurance premium, we can reduce that premium in the current fiscal year and by not spending those dollars we can instead allocate them to one time expenditure, and as you saw the FY17 budget proposed us a lower level of premium expenditure. So a decrease of \$8.3 million in general funds for the state employee health insurance premium. Also, state aid a decrease of \$3.1 million in general funds in state aid to general education due to 277 fewer students than budgeted and higher property valuation growth than budgeted. And finally, utility rate adjustments decrease of \$1.3 million in general funds due to reduced costs and lower usage in the utility budget.

Here are the proposals to spend that \$60 million. First, \$42.3 million will be used to prepay bonds and repurpose the saved payments for tuition freezes, as I've already described. \$2.4 million is to backfill the Extraordinary Litigation Fund, for litigation expenses not covered by the Public Entity Pool for Liability or PEPL fund. That amount is \$2.4 million.

Native American Student Achievement – \$2.2 million is to improve the educational outcomes for Native American students based on the recommendations of the Native American Student Achievement Advisory Council. Their report was just issued, and it should be available to you.

Fire Suppression Fund to backfill \$2.1 million for wild fires we've been fighting the past year.

Need Based Scholarship Endowment – \$2.1 million. During the 2013 Session, some of you will remember, the Legislature established an endowment fund to ensure that needy students are not discouraged from pursuing a posts secondary degree. My proposal would add \$2.1 million to the current endowment of \$1.5 million. And in addition to this, I'm proposing that \$1.4 million of Board of Regents other funds, which are available to their own one-time decrease in the health insurance rates, go towards the endowment, so that would bring the endowment to \$5 million between those three funds – the existing dollars, our \$2.1 million, and the Board of Regents \$1.4 million – a total of \$5 million.

South Dakota Developmental Center building demolition, this \$1.8 million is for the demolition of three buildings on the South Dakota Developmental Center at Redfield. Demolishing these buildings is part of the Department of Human Services overall plan to reduce that footprint and reduce maintenance costs.

Game, Fish, & Parks bond obligations a \$1 million, this amount is for Game, Fish, & Parks bond payments. A like amount of Game, Fish, and Parks other funds is transferred into the general fund resulting in a zero impact.

Railroad development – I am proposing \$1.0 million for new loans for rail infrastructure projects to have this million go into the railroad trust fund.

Medicare Part premium – \$954,000 for mandatory Medicare Part B premium payments.

Correctional healthcare – \$736,000 is for significant inmate healthcare costs.

Miscellaneous remaining one-time expenses total \$3.5 million. They include things like a new online business registration system for the Secretary of State, funding for shortfalls in the Dual Credit program and Birth to Three program in the current year, and tax refunds for elderly and disabled. Some of these you've seen before.

Then out of other, non-general fund. I propose three special appropriations, one you've seen every year – the water omnibus bill. I'm proposing \$16.3 million there for the water and environment fund, the water pollution control revolving sub fund, and the drinking water revolving sub fund for water and environmental purposes. Then I'm proposing \$1,575,000 for the animal disease research and diagnostic laboratory design study for the design study of a new lab at SDSU. And then \$1 million for the coordinated natural resource conservation fund. We've made an appropriation like that in the past so that should be familiar to you.

The total recommended budget is \$4.4 billion recommending over \$4.8 billion in total spending in FY17. In addition, my proposal reduces full-time staff equivalent by 63 in FY17, for a total of 13,940 FTE. Both years are honestly balanced, without employing any of the borrowing or accounting gimmicks seen in some other states.

As I mentioned before, the topics of Medicaid expansion and education reform have significant budget implications, but also are important policy discussions that I look forward to this session.

This is an exciting time for South Dakota. We have managed our state well I believe, and we have the opportunity to make great progress this year. I stand ready to join with the Legislature as we develop solutions to these and the other opportunities that face our great state.

South Dakota is working. We're working better than many other states. We can proudly say we've balanced our budget honestly. Next year will be our 127th year. We have prudently set aside rainy day funds that allow us to address emergencies and seize opportunities that are available to us. We've made structurally balanced budget the norm. We've used one-time dollars prudently, ensuring they do not become an ongoing obligation. We've paid off even more debt. We have a state pension fund that is over 100% funded – that's a rare thing in today's world. We have memorialized financial practice improvements in statute. We've put those things in statute to help guide our state for the long-term, even when we're not here anymore. These practices are all paying dividends.

As you know, Standard & Poor's upgraded South Dakota's Issuer Credit Rating (ICR) to AAA last May. We've met with all three rating agencies, and we're going to continue to meet with them annually. I am confident that more AAA designations will be coming to our state in these financial arenas.

I look forward to continuing this work with you this year. Through your efforts we're building an even stronger South Dakota. Thank you for your service to our state, and thank you for your time this afternoon.